

Testimony: Joint Economic Committee, July 9, 1991

**Monetary Reform in the U.S.S.R.**  
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**Moscow September 17, 1990**

I speak today with considerable diffidence. I know little about the economy of the Soviet Union or about its monetary system. My training in economic research has taught me to be skeptical of instant experts, and I want to avoid appearing as one of them. Many such experts have come to the Soviet Union. Some of their advice may be useful, some not.

There are a few things about which I feel confident. One is that there is no blueprint, road map or design for bringing an economy from central planning to the market system in a series of carefully designed steps. Second, the major steps to be taken require that institutions be changed. You must learn to trust the public, and to let their signals guide resource allocation. Private property, a market system and competition provide a means by which those signals get transmitted. Third, you are unlikely to get to a well functioning market economy by half steps. You must be willing to make major structural changes.

You should know that there are successful and unsuccessful market economies. There is Argentina or Brazil, and there is the U.S., Germany, Japan, Taiwan or Hong Kong. The differences are enormous. Some are overly regulated and uncompetitive, and the state directs investment and produces inflation. The more successful countries seek to provide price stability and encourage competition.

To succeed, you do not have to adopt the details of the Japanese, German, U.S. or other model. But, you must adopt some rules that have been found to be successful. To avoid inflation, there must be a formal commitment that frees the central bank from financing the government or the state enterprises. You will not achieve price stability unless there are fiscal and other reforms. The goal of price stability is meaningless if most prices remain controlled. But, freeing prices is not enough. To get the benefits of the market system, you must permit, even encourage, competition

among domestic suppliers, and between domestic and foreign suppliers. This means you must move toward much freer trade in goods and services.

I can summarize much of the rest of my comment in three words -- credibility, flexibility and applicability. After discussing each of these in turn, I will add a few words about the so-called monetary overhang that is said to be a problem for the Soviet Union.

## **Credibility**

One of the most urgent tasks is to get people accustomed to using price signals -- relative prices changes -- to guide resource allocation. The monetary authority can best contribute to this task by assuring that the price signals are as clear as they can be. Price stability removes the problem of separating general and relative price changes and reduces the problem of separating temporary and permanent changes in the price level. The signals from demand, cost or productivity changes are then easier to interpret. The quality of the information provided by the price system improves. This in turn, increases efficiency.

In principle, there are several ways in which the monetary authority can maintain price stability. The principal alternatives are either fixing the exchange rate or adopting some fixed or adaptive rule for money growth. Either of these rules will work if the rule is consistent with price stability, and the public believes that the central bank will follow the rule. Neither rule guarantees success. A fixed exchange rate rule runs the risk that the exchange rate will not be consistent with price stability or, as Chile learned in the 1980s, that the real exchange rate is revalued. A monetary rule will have difficulty with velocity changes in a rapidly changing economic system.

Establishing credibility -- the belief that the central bank will follow the rule -- is a particularly difficult problem for the Soviet Union. Under the centralized planning system, the state bank financed not just the excess of spending over receipts in the government budget but in the budgets of all the enterprises. As we know from experience, if the state bank (or the central bank) continues to finance all budgets on demand, inflation will not be avoided, and credibility will not be established once

prices are no longer controlled.

Credibility for the new monetary policy can be achieved most effectively if the new system is seen to be a major departure from the old, and the opportunities for discretion are severely restricted. The public must be convinced that the central bank and government will honor their commitment to avoid inflation. I suggest that this is done most effectively if you restrict the government's monetary role by establishing a monetary authority like the Hong Kong or Singapore Monetary Authority. In such systems the exchange rate is fixed. The authorities are empowered to issue money only if they receive convertible currency, and they must withdraw money when they lose convertible currency. They collect seigniorage, but they have no discretionary authority to change the quantity of money and no legal means of doing so. Money can only be issued to the extent that the country earns convertible currency.

This system has several advantages. Most important is the durability of the commitment. Like Ulysses, in the ancient Greek legend, you will have bound yourself tightly. There are other advantages. Let me spell out a few. First, the system focuses attention on the need to compete in world markets. Efficiency in international markets begets domestic efficiency, and increased domestic efficiency encourages exporting. Second, domestic prices would adjust toward world levels. If the exchange rate is fixed to the dollar or the mark, domestic commodity prices will move toward U.S. or German prices for goods of the same quality. Third, interest rates will fall toward the world level. At first there would be a risk premium but the premium would decline as confidence grows that the system will be maintained. Fourth, budget deficits would be limited. All borrowing, whether denominated in domestic or foreign currency, would have to be financed from domestic or foreign saving. The market would limit borrowing by raising the interest rate as borrowing increased.

The monetary authority would be limited to a few monetary functions. A banking authority, or financial market authority, would have the important task of developing and supervising a competitive banking and financial system to increase the efficiency with which savings are allocated and investment financed.

This would be a strong commitment. The closer you come to it, the more it will be believed. A mixed system in which the exchange rate is fixed but adjustable will be

less credible. If people doubt your commitment to monetary stability they will charge risk premiums in interest rates and wages to pay for possible inflation.

### **Flexibility**

Under the system of material balances and central planning, prices had no allocative role. Resource allocation and pricing were unrelated, and prices changed infrequently. In a market economy, prices change frequently and guide the allocation of resources. Price stability means that a broad based price index is stable, but individual prices change. Flexibility of individual prices lets the market respond to changes in relative demand or relative scarcity.

Flexible costs and prices can reduce fluctuations in employment and output. Developed markets contribute to price flexibility. In your country, where price and wage flexibility has been rare for decades, reliance on flexible prices and wages to signal the appropriate reallocation of resources is likely to develop slowly. People must learn to follow the signal. And they must learn that rising prices for the goods or services that they buy is not necessarily a sign of anti-social behavior by the sellers. We know from our own experience that this is a difficult lesson to learn. Large increases in the prices of consumer goods in the United States often lead to claims that speculators and profiteers are responsible for the rise and to calls for lower prices, controls or investigations. Large declines in price lead to demands for protection, subsidies or minimum prices. Government responses to these outcries typically reduce price flexibility, thereby making the economy less efficient and less competitive. The information provided by the price system to guide resource allocation is suppressed.

### **Applicability**

Monetary reform is a useless gesture unless it is part of an economic reform that allows prices to adjust. Monetary reform and price flexibility should be parts of a comprehensive reform program that includes the establishment of open, competitive

markets in a wide range of goods, services, labor and assets. For it is competition in a market economy that reduces monopoly power and induces self interested individuals to provide the social benefits that free markets generate. And, it is the right to keep the gains and the responsibility to accept losses that induces people to compete. Hence, establishment of private property and other institutions, such as accounting and legal systems that help to sustain competitive markets, must be part of the reform.

The United States and other private property, free market economies place many restrictions on property and markets. Some of these are introduced to equate private and social costs, as in the case of pollution, or to protect minors or others. Some are designed to redistribute income. The type of market system that is most likely to endure is a democratic, capitalist system with its tensions between efficiency, growth, and redistribution. Redistribution requires taxes, and high taxes reduce effort or shift activity away from established markets. Heavy intervention and redistribution reduce the likelihood of a successful transition to democratic capitalism.

Those who question the applicability of the market system to Eastern Europe or the Soviet Union typically do not have these restrictions in mind. Those who raise the issue of applicability question whether private property and competitive markets will produce growth, raise living standards and increase efficiency in their countries.

The argument often made is that experience and the established culture are so different in the Soviet Union that individuals will not respond to the type of incentives that have worked elsewhere. We know that this cannot be wholly true. People from all of the cultures and countries of the world have responded to market incentives in the United States and there is now additional experience in a wide variety of cultures. And the prevalence of "black markets" and other private arrangements suggests that entrepreneurs are not unknown in Eastern Europe and the Soviet Union. Increased competition is the way to get these entrepreneurs into more productive activities.

I believe that an important distinction is often neglected in discussions of applicability of the price system. Misleading language contributes. We talk about people "working for money," but, money is only a means of buying goods or assets. People produce and innovate to acquire goods, services and assets. That is why monetary reform alone is not sufficient. It must be part of a social and economic reform

that puts toasters, washing machines, dryers, TVs, cars, houses and the like into stores in every city and village and provides an infrastructure that includes roads and electricity to make these durables useful to a large part of the population. Productive reform produces incentives by providing opportunities for accumulation and for improved living standards.

### **Monetary Overhang**

President Gorbachev says that there is a "monetary overhang" equal to 100 billion rubles. Others suggest that the overhang is 3 or 4 times greater. A "monetary overhang" is a type of forced saving in the form of cash balances that people would spend if more goods and services were available. The concern is that, if prices are decontrolled, prices will rise as people seek to shift from money to goods. The fear that others will behave in this way encourages a flight from money, for the anticipated increase in prices will reduce future purchasing power. A sustained flight from money could produce hyperinflation.

There are two solutions to this problem -- increase the supply of goods or reduce the stock of outstanding money. Currently, in most of Eastern Europe, the first requires imports. The second calls on the government to withdraw money from circulation by selling assets, including housing, and state enterprises, or selling some type of indexed bond that pays a positive real rate of interest. If you replace the state bank with a monetary authority, as I have suggested, the bonds should be denominated in the currency to which domestic money is pegged.

I see no reason to choose between these alternatives. Governments should offer assets, including indexed bonds, to privatize ownership and absorb excess supplies of money. If the monetary authority fixes the exchange rate and maintains convertibility, the public can buy imported goods. Ten or twenty billion dollars of imported goods would absorb much of the overhang at the current market exchange rate. Once the public becomes convinced that the exchange rate will remain fixed and prices will remain stable, they will choose to increase cash balances. Thus, credible policies reduce monetary overhang both by withdrawing money from circulation and by increasing the demand for money.

Postscript, July 1991

The advice I gave almost a year ago has not been followed. No one will be surprised. The Soviet Union has continued to flounder without leadership or direction in economic affairs

The problem is theirs to solve, not ours. We can neither reform the Soviet economy nor purchase their acceptance of private property and a market system. Well-intentioned plans to lend money to the U.S.S.R. or to the individual republics are bound to waste resources, ours as well as theirs.

The reasons are clear. Loans to their government would strengthen the power of those governments over resource allocation. They would sustain central authorities. What is needed is the opposite--decentralization. Further, part of the loans to governments will be used to delay economic reforms, modernization, reductions in military spending, and privatization.

Our loans should be made, after privatization, to bona fide private corporations. They should be made commercially, not governmentally, by those willing to bear the risk.

We should offer assistance to privatization by offering technical assistance, including management training and training in the operation of a market economy. We should encourage them in their efforts, but our commitment should be limited to humanitarian aid and technical assistance.